

FEDERAL INCOME TAXATION—PUBLIC POLICY AND THE DEDUCTIBILITY OF KICKBACKS UNDER § 162(c)(2)

I. INTRODUCTION

The "public policy" doctrine, now codified in § 162 of the Internal Revenue Code, disallows deductions for bribes, kickbacks, and other illegal payments, lobbying expenses, fines and penalties, and treble damage payments under the antitrust laws. The doctrine, promulgated in the courts before the policy sections of the statute were enacted, rests on a compromise between the goal of taxing net rather than gross income, and that of avoiding the appearance of subsidizing illegal activities through tax deductions. Under that policy, expenditures recognized as ordinary and necessary business expenses are nonetheless denied deduction because they are illegal or closely connected with illegal activity. In general, critics of the public policy doctrine say that it perverts the policy of taxing only net income and that it involves the Internal Revenue Service in the enforcement of laws outside its domain.¹

This note is confined to arguments showing that the public policy doctrine with regard to commercial bribes and kickbacks² is even more

¹ See, e.g., Crouter, *Revenue Act of 1971 Restricts Deductions of Illegal Bribes, Kickbacks and Referrals*, 48 LOS ANGELES B. BULL., Jan. 1973, at 96; Diamond, *The Relevance (or Irrelevance) of Public Policy in Disallowance of Income Tax Deductions*, 44 TAXES 803 (1966); Ellis & Beck, *New Law Clarifies Treatment of Fines, Penalties, Bribes and Antitrust Payments*, 32 J. TAXATION 276 (1970); Gordon, *The Public Policy Limitation on Deductions From Gross Income: A Conceptual Analysis*, 43 INDIANA L. J. 406 (1968); Koster, *Fines, Kickbacks, and Illegal Business Operating Expenses: When Are They Deductible?*, 3 TAXATION FOR ACCOUNTANTS 340 (1969); Lindsay, *Tax Deductions and Public Policy*, 41 TAXES 711 (1963); Paul, *The Use of Public Policy by the Commissioner in Disallowing Deductions*, 1954 SO. CALIF. TAX INST. 715; Reid, *Disallowance of Tax Deductions on Grounds of Public Policy—A Critique*, 17 FED. B. J. 575 (1957); Schwartz, *Business Expenses Contrary to Public Policy: An Evaluation of the Lilly Case*, 8 TAX L. REV. 241 (1953); Taggart, *Fines, Penalties, Bribes and Damage Payments and Recoveries*, 25 TAX L. REV. 611 (1970); Van Alstyne, Jr. & Barton, *Income Tax Litigation: The Arena for Morals?*, 38 NBD. L. REV. 692 (1959); Note, *Public Policy and Federal Income Tax Deductions*, 51 COLUM. L. REV. 752 (1951); Comment, *Business Expenses, Disallowance, and Public Policy*, 72 YALE L.J. 108 (1962).

² Payments made to domestic or foreign governmental officials are specifically excluded from the scope of this note. Commercial bribery is the payment of money to an agent or employee of another, made without the principal's knowledge or consent, with the intent to influence the agent's or employee's action in relation to his principal's business. Bribes and kickbacks are to be distinguished from rebates, which are discounts whose benefit the principal receives, and from tips, which are kept with the principal's consent to augment a small wage.

Commercial bribes have been made by all kinds of sellers (of meat, varnish, soap, ship supplies) to all kinds of buyers (chefs, foremen, purchasing agents, ship captains). Their form and degree vary from twenty-dollar cash payments to Christmas gifts of Wyeth originals and weekend trips to lavish estates. A recent estimate puts the annual flow of commercial bribes at five billion dollars: ten times the loss to business from shoplifting. The cost of a kickback is passed on first to the buyer and ultimately to the consumer in the form of higher purchase prices or inferior grades of merchandise.

confused in its formulation and cumbersome in its application than it is with respect to other expenses similarly denied deduction. None of the Supreme Court cases in which the public policy doctrine was developed outline reasons for disallowing the deduction of kickbacks except in dictum. An examination of these dicta reveals that reasons for including illegal payments within the class of expenses denied deduction under the public policy doctrine are questionable. These apparently conflicting dicta could have been reconciled by a reasonable and narrow reading which would have confined the disallowance of kickback deductions for policy reasons to those payments previously found illegal by a state or federal nontax agency. Instead, courts in cases since *Commissioner v. Sullivan*³ and *Tank Truck Rentals, Inc. v. Commissioner*⁴ have generally assumed the burden of determining whether a taxpayer's questionable payments were illegal as a first step in determining tax liability. A survey of cases decided since 1958 demonstrates that the assumption of this task as a part of tax litigation has introduced complex problems of construction of nontax statutes, of allocation of the burden of proof of guilt under nontax statutes, and of duplication of the enforcement policies of nontax agencies.

These problems have arisen solely because illegal payments, unlike fines, penalties, or treble damage payments under the antitrust laws, are usually denied deduction at a pre-enforcement stage, when there has been no determination that the taxpayer has violated any law. Principles of intergovernmental comity as well as the practical problems of determining guilt within the process of tax litigation suggest that the disallowance of deductions for kickback payments for public policy reasons should be confined to those cases in which the payments have already been found illegal. This limitation would bring the treatment of illegal payments under the public policy doctrine into line with the treatment of fines and penalties as well as conforming to a permissibly narrow reading of the public policy dicta in *Sullivan* and *Tank Truck*.

Versions of § 162(c)(2) passed in 1969 and 1971 parallel the suggested limited doctrine with respect to kickbacks and the cumbersome one developed by courts, respectively. The latter statute, besides preserving a policy which would better be limited or abandoned, is cast in

The financial and moral costs of widespread commercial bribery are discussed in J. FLYNN, *GRAFT IN BUSINESS* (1931); N. JASPAN & H. BLACK, *THE THIEF IN THE WHITE COLLAR* (1960); Stevens, *Some Economic Consequences of Commercial Bribery*, 7 HARV. BUS. REV. 156 (1929). These works paint a distressing picture of how pervasive commercial bribery is. Tax Court and Federal Trade Commission reports provide detailed accounts of the bribery practices of some individual businesses.

³ 356 U.S. 27 (1958).

⁴ 356 U.S. 30 (1958).

such vague and confusing language that taxpayers may now find it harder to predict the tax status of their illegal payments than they did before the public policy doctrine was codified.

II. THE FORMULATION OF THE PUBLIC POLICY DOCTRINE AS IT RELATES TO KICKBACKS

The Supreme Court cases which established the public policy doctrine throw no direct light on the deductibility of commercial bribes or other payments made in violation of state or federal law. In *Commissioner v. Heininger*,⁵ attorney fees were incurred by a mail-order dentist in the unsuccessful resistance of a fraud order issued by the Postmaster General. In allowing deductions for these fees, the Court said that disallowance of an otherwise ordinary and necessary business expense was proper only when allowance would "frustrate sharply defined national or state policies proscribing particular types of conduct."⁶ In *Lilly v. Commissioner*,⁷ an optician paid kickbacks to the ophthalmologist who had referred patients to him to have their eyeglasses made. The deduction was allowed because no applicable state statute made such payments illegal; no public policy existed which such payments, however reprehensible, could frustrate. The taxpayer had only to show that the payments were ordinary and necessary to be allowed the deduction. The Court's reference to the public policy expressed in *Heininger* is stated hypothetically:

Assuming for the sake of argument that, under some circumstances, business expenditures which are ordinary and necessary in the generally accepted meanings of those words may not be deductible as "ordinary and necessary" expenses under § 23(a)(1)(A) [now § 162(a)] when they "frustrate sharply defined national or state policies proscribing particular types of conduct," . . . nevertheless the expenditures now before us do not fall in that class. The policies frustrated must be national or state policies evidenced by some governmental declaration of them.⁸

In *Tank Truck Rentals, Inc. v. Commissioner*⁹ a truck operator was denied deduction of fines incurred for intentional as well as innocent violations of a state motor vehicle maximum weight statute. The Court held that "the test of nondeductibility is always the severity and immediacy of the frustration resulting from allowance of the deduction"¹⁰ and went on to speak of illegal payments:

⁵ 320 U.S. 467 (1943).

⁶ *Id.* at 473.

⁷ 343 U.S. 90 (1952).

⁸ *Id.* at 96-97.

⁹ 356 U.S. 30 (1958).

¹⁰ *Id.* at 35.

Certainly the frustration of state policy is most complete and direct when the expenditure for which deduction is sought is itself prohibited by statute. . . . If the expenditure is not itself an illegal act, but rather the payment of a penalty imposed by the State because of such an act, as in the present case, the frustration attendant upon deduction would be only slightly less remote, and would clearly fall within the line of disallowance.¹¹

In *Commissioner v. Sullivan*,¹² decided the same day as *Tank Truck*, the rental and wage expenses of an illegal gambling operation were held deductible. Although their payment violated a state statute, no federal statutory or regulatory disapproval of these expenses existed, and such expenses were ordinary and necessary business expenses "in the accepted meaning of the words."¹³ Such deductions were to be permitted "unless it is clear that the allowance is a device to avoid the consequence of violation of a law . . . or otherwise contravenes the federal policy expressed in a statute or regulation."¹⁴ On the surface the statements of *Tank Truck* and *Sullivan* relating to payments prohibited by state law seem to conflict, or at least to leave undetermined the circumstances under which a payment made in violation of a state law will be disallowed as a deduction. These opinions speak of public policy, as it affects the deductibility of illegal payments, outside the context of the facts of the cases decided. Dictum has followed dictum, and the more the Supreme Court has said about public policy in general, the less clear public policy as to kickbacks in particular has become.

Section 162(c)(2) of the Internal Revenue Code was added by the Tax Reform Act of 1969.¹⁵ It provided for the nondeductibility of illegal bribes or kickbacks to persons other than governmental officials only if the taxpayer was convicted in a criminal proceeding, or entered a plea of guilty or of nolo contendere in such a proceeding. Since the enforcement of state commercial bribery statutes is lax, and since most federal prohibitions of commercial bribery are administrative rather than criminal, this provision had the effect of exempting illegal bribes and kickbacks from the public policy doctrine and allowing their deduction upon a

¹¹ *Id.*

¹² 356 U.S. 27 (1958).

¹³ *Id.* at 29.

¹⁴ *Id.*

¹⁵ Act of December 30, 1969, Pub. L. No. 91-172, § 902(b) provides:

If in a criminal proceeding a taxpayer is convicted of making a payment (other than a payment described in paragraph (1)) which is an illegal bribe or kickback, or his plea of guilty or nolo contendere to an indictment or information charging the making of such a payment is entered or accepted in such a proceeding, no deduction shall be allowed under subsection (a) on account of such payment or any related payment made prior to the date of the final judgment in such proceeding.

showing that they were ordinary and necessary. The Revenue Act of 1971 repealed that subparagraph retroactively and substituted the present § 162(c)(2),¹⁶ which disallows the deduction of payments made in violation of (1) any federal law or (2) any state law which subjects the taxpayer to a criminal penalty or a loss of license, if that law is generally enforced. This statute appears to be more coherent, comprehensive, and direct than the Supreme Court opinions that formerly provided indirect policy statements on the subject of commercial bribes. Nevertheless, objections arise. First, this most recent addition¹⁷ to the class of expenditures against public policy does not really represent the most complete and direct kind of frustration of state policies, even though *Tank Truck* appears to say it does. Second, the statute, while providing a uniform source of authority for tax litigation, also broadens the means by which state and federal policy are to be implemented—so much so that it extends tax enforcement beyond the scope of the policies it allegedly serves.

A. *The Degree to Which Kickbacks Frustrate the Public Policy as Formulated in Tank Truck*

According to *Tank Truck*, the frustration of public policy is most complete and direct when the payment made in its violation is itself illegal. On its face, this statement means that illegal bribes and kickbacks, however ordinary and necessary, constitute that form of expenditure public policy doctrine finds most heinous. But because a payment is illegal is not the only, or even the best, reason for denying its deductibility. When the agency charged with assessing an income tax distorts the net income formula upon which that tax is based, it ought to do so only because of the most pressing requirements of avoidance of conflicts with the policy of its own or other governmental branches. Thus, the deduction of fines and penalties is disallowed because another state or

¹⁶ INT. REV. CODE OF 1954, § 162(c)(2) provides:

No deduction shall be allowed under subsection (a) for any payment (other than a payment described in paragraph (1)) made, directly or indirectly, to any person, if the payment constitutes an illegal bribe, illegal kickback, or other illegal payment under any law of the United States, or under any law of a State (but only if such State law is generally enforced), which subjects the payor to a criminal penalty or the loss of license or privilege to engage in a trade or business. For purposes of this paragraph, a kickback includes a payment in consideration of the referral of a client, patient, or customer. The burden of proof in respect of the issue, for purposes of this paragraph, as to whether a payment constitutes an illegal bribe, illegal kickback, or other illegal payment shall be upon the Secretary or his delegate to the same extent as he bears the burden of proof under section 7454 (concerning the burden of proof when the issue relates to fraud).

¹⁷ Act of December 30, 1969, Pub. L. No. 91-172, § 902(a) added § 162(f) and § 162(g) of the INT. REV. CODE OF 1954, which disallow the deduction of fines and penalties, and of two-thirds of treble damage payments incurred under the antitrust laws, respectively.

federal enforcement agency that levied the fine has already determined that the taxpayer has violated some public policy. The deduction of bribes and kickbacks to government officials is denied because of the duty the Internal Revenue Service owes to itself and other branches not to help subsidize their corruption. No such direct governmental action against the taxpayer himself, or such overriding governmental interest in the recipient of the payment, justifies the disallowance of a deduction for kickbacks in the absence of a previous governmental determination of the taxpayer's guilt.

Only a handful of federal income tax cases in which the deductibility of a commercial bribe or illegal payment was in question were preceded by any nontax agency's direct action against a specific taxpayer's illegal payments.¹⁸ The only case decided before *Tank Truck* and *Sullivan* in which a state enforcement agency had found a taxpayer's payments to have violated a state statute is *Boyle, Flagg & Seaman, Inc.*¹⁹ The taxpayer-insurance broker had split policy-writing commissions paid to it by insurance companies with auto dealers from whom it had received referrals of auto purchasers in need of additional insurance. An Illinois law provided that only parties licensed by the state could receive insurance commissions, and an inquiry into the taxpayer's payments to the unlicensed auto dealers was followed by a hearing and the issuing of an official reprimand by an administrative agency of the State of Illinois. The taxpayer was not fined, nor was his license suspended. The Tax Court

¹⁸ In *G. E. Fuller*, 20 T.C. 308 (1953), *aff'd* 213 F.2d 102 (10th Cir. 1954) and *Hiram E. Bowles*, 1954 P-H Tax Ct. Mem. 510 taxpayers bought and sold liquor in violation of state statutes. Each was raided by police who seized his liquor stock and never returned it, although in *Fuller* no charges were mentioned and in *Bowles* the state case against the taxpayer was dismissed for lack of evidence. Both taxpayers were denied loss deductions for the confiscated liquor on the grounds that since the purchase of liquor for purposes of resale was illegal, the taxpayers could have no property interest in the liquor and therefore had suffered no loss when it had been seized. These cases are confusing because the taxpayers were allowed to include the cost of unconfiscated liquor in cost of goods sold, the goods being liquor in which, according to the Tax Court's reasoning, the taxpayers also had no property interest, so that they could have had no expenses in acquiring something they did not own, nor a cost of goods sold for something which was not theirs to sell.

In *Coed Records, Inc.*, 47 T.C. 422 (1967) the taxpayer, a record manufacturer and distributor, was denied deductions for the payola money he had paid to disc jockeys in violation of the New York commercial bribery statute. No state criminal charges had been filed against the taxpayer, but two of the disc jockeys who had received payments had been indicted under that statute and one of them had pleaded guilty. The Tax Court rejected arguments that, since the taxpayer itself had not been charged under the New York statute, it was not within the province of the Tax Court to decide that the taxpayer had violated that law, and the deductions should therefore not have been denied. The court held that the presentation of the public policy question made it incumbent upon the Tax Court to determine whether the taxpayer had violated the statute in order to decide whether a frustration of state policy had occurred, even if no state court or other state authority had made such a determination.

¹⁹ 25 T.C. 43 (1955).

disallowed the deduction of \$23,908.90 paid to unlicensed auto dealers in 1948 and \$46,085.28 paid in 1949.

Boyle, Flagg & Seaman, Inc. is the only case cited in *Tank Truck* in support of its statement that "[c]ertainly the frustration of state policy is most complete and direct when the expenditure for which deduction is sought is itself prohibited by statute."²⁰ The citation of this case, unique even since *Tank Truck* in the history of the public policy doctrine, raises doubts about the scope of the statement it supports. A permissibly narrow reading of the *Tank Truck* policy statement would be that payment for which deduction is sought can be found to be prohibited by statute only when a state or federal agency outside the tax system has made a prior determination of the taxpayer's guilt. This reading would help to reconcile *Tank Truck* with the apparently contradictory result in *Sullivan*. While rent and salary expenses of illegal gambling operations such as the Sullivans' are costs whose payment was forbidden by Illinois law, no mention is made of any determination by a state enforcement or other nontax agency that the taxpayer had violated that law. So distinguished, the *Boyle* and *Sullivan* illegal payments can reasonably receive different tax treatment under the public policy doctrine, as in fact they did.

Under this reading, the apparent scope of *Tank Truck*'s public policy statement on illegal payments diminishes sharply, since only one case could be found to which it applied. At the same time the statement gains credibility through its limitation: when a governmental agency has previously found a taxpayer guilty of making an illegal payment, that taxpayer has been found to have violated public policy completely and directly before the question of a tax deduction even arises. Such a finding by a nontax agency is a specific expression of governmental policy to which, like the levying of a fine or penalty, the Internal Revenue Service can most properly demonstrate intergovernmental comity through denial of a deduction. Such a denial is more appropriate than one made in the absence of any previous finding of guilt, just as the denial of a deduction for fines and penalties is proper only when fines have actually been exacted.

Only one court since *Tank Truck* has explicitly read the public policy doctrine to apply so narrowly to illegal payments. In *Kirtz v. United States*,²¹ the insurance agent-taxpayer had kicked back portions of his policy-writing commissions to a finance company subject to an arrangement similar to that in *Boyle*. During a general investigation of insur-

²⁰ 356 U.S. at 35.

²¹ 304 F.2d 460 (Ct. Cl. 1962).

ance practices, the Internal Revenue Service discovered that the taxpayer and other insurance agents were paying rebates for new business, that the payment of such rebates was widespread, and that their payment violated Ohio law. When the Ohio Department of Insurance was notified of these infractions, it took no action against the taxpayer and did not even tell him to refrain from making his illegal rebates. In tax litigation before the Court of Claims, the Internal Revenue Service invoked the violated Ohio law and the public policy doctrine, citing *Tank Truck, Hoover Motor Express Co. v. United States*,²² *Heininger*, and *Boyle*. The court allowed the deduction on the ground that, since no state determination of the taxpayer's guilt had been made, no public policy which his own payments violated had been articulated:

The Boyle case, and every case relied on by the defendant, contained an element lacking in the present action; i.e., a determination by the authority charged with the enforcement of the state or federal law or the carrying out of the public policy involved that the expense for the deduction sought was incurred in violation of that law or well-defined public policy. Lacking any such determination, we are of the opinion that an allegation by the Internal Revenue Service that the expense was incurred in violation of a state statute is insufficient to disallow an otherwise proper deduction unless the expense occasioned an act *malum in se*. To permit the Internal Revenue Service to employ Federal tax law in an effort to enforce its concept of state law as the Service views it would be an unnecessary extension of its delegated authority, at the very best, and creates a disruptive atmosphere of interference by the Federal Government in an area traditionally reserved to the states. Inasmuch as the Ohio Superintendent of Insurance was apprised of the activities herein discussed and did not determine that a well-defined public policy was being violated, we are of the opinion that neither the Internal Revenue Service nor this court should provide that determination.²³

In other words, a complete and direct frustration of state policy does not occur whenever an illegal payment has been made, but only when a state authority has declared that its policy has been violated by an individual taxpayer.

B. *Implementation of the Public Policy Doctrine as Formulated in Tank Truck*

Unfortunately, *Sullivan's* characterization of the payments whose deductibility was in question as legal expenditures of an illegal business, rather than as payments themselves forbidden by law, means that the

²² 356 U.S. 38 (1958) (a companion case to *Tank Truck* in which fines paid for inadvertent violations of motor vehicle weight law were denied deduction).

²³ 304 F.2d at 463.

public policy doctrine expressed in *Tank Truck* and in *Sullivan* was formulated absent any direct determination of an illegal payment. The reliance on dictum required by such an omission has understandably led to judicial and statutory confusion. While a reading of the *Tank Truck* statement on illegal payments as narrow as the one suggested above might have been applied, cases since *Tank Truck* and *Sullivan* show that courts have read the public policy doctrine as it applied to illegal payments to allow a much broader application of the public policy doctrine to payments not previously held illegal. The result has been the gradual interjection of the complexities of a criminal trial into federal income tax litigation.

1. Avoidance of the Public Policy Doctrine

One approach to an increasingly complex doctrine has been to avoid its construction altogether by finding that payments are not ordinary or necessary on non-public policy grounds. Two tax court cases illustrate this approach. First, in *Sanford Reffer*²⁴ a deduction was denied for contingent witness fees paid in an action for damages to the taxpayer's business. While no state statute specifically forbade such payments, they were void as against public policy. The court held, however, that the tax deduction need not turn on public policy grounds because such payments were not the "common and accepted [ordinary] means used by a coal operator or any other person in prosecuting an action for damages to his business."²⁵ In the following year, in *Frederick Steel Co.*,²⁶ a finished steel jobber was denied a deduction for kickbacks to a customer's purchasing agent. In response to an officer's testimony that he knew of many such arrangements, the court said: "Such self-serving, unconvincing testimony falls far short of establishing that payments in the nature of commercial bribes were common [ordinary] in this segment of the steel industry."²⁷ Likewise, in *United Draperies, Inc. v. Commissioner*²⁸ the Seventh Circuit denied a deduction for kickbacks paid to vice-presidents of the trailer manufacturing companies the taxpayer supplied. The court recognized that kickbacks occurred but said they were not an ordinary means of securing or promoting business.

Despite these courts' denial that any public policy issues had arisen, the tone of their opinions suggests that they were moved by considera-

²⁴ 39 T.C. 869 (1963).

²⁵ *Id.* at 878.

²⁶ 42 T.C. 13 (1964), *rev'd on other grounds*, 375 F.2d 351 (6th Cir. 1967).

²⁷ 42 T.C. at 25.

²⁸ 340 F.2d 936 (7th Cir.), *aff'g* 41 T.C. 457 (1964).

tions of legality or morality in refusing to find that the taxpayers' expenditures were ordinary. The outraged disbelief with which they received claims, even testimony, of widespread illegal payment practices, had the effect of increasing the taxpayers' burden of providing that such payments were ordinary and necessary. Moreover, the courts' explicit refusal to consider the illegality or immorality of the payments meant that this added burden of proof had been imposed in the absence of any finding, even one made in the course of tax litigation, that the taxpayers had in fact violated state law.

2. Construction of Statutes Which Prohibit Certain Payments

Courts that do apply the public policy doctrine to payments of questionable legality have found that, since no previous determination of guilt has been made, they must construe state or federal law to determine whether a violation, and thus a frustration of public policy, has occurred.²⁹

In *Dixie Machine Welding & Metal Works, Inc. v. United States*,³⁰ the ship chandler-taxpayer's questionable payments were kickbacks paid to captains and engineers of foreign ships. Louisiana's commercial bribery statute forbade the making of such payments without the knowledge

²⁹ In *United States v. Winters*, 261 F.2d 675 (10th Cir.), *rev'g* 1 AFTR 2d 644 (N.D. Okla. 1958), the taxpayer tried to deduct the cost of four cases of liquor he had purchased for business entertainment use in his home. While purchase and possession of liquor for personal use were permissible in Oklahoma, a state statute made it unlawful for anyone to sell, barter, give away, or otherwise furnish liquor. The district court allowed the deduction, saying that the statute prohibited only giving away liquor as a subterfuge for an illegal sale, and the legality of possession of liquor for personal use was not limited to liquor used for personal consumption only.

The Tenth Circuit reversed, holding that personal use included only purely social, nonbusiness entertainment, so that the taxpayer's distribution of liquor to his business guests was illegal. Although no statute forbade the purchase of the liquor, the court denied the deduction of its cost because the expenditures were made for an illegal purpose, whose accomplishment required the commission of illegal acts by the taxpayer's vendor in addition to the taxpayer's illegal distribution. Thus state law had been violated in acts closely connected with the legal purchase, and the court held that "the severity of the frustration is not diminished by the fact that the purchase violated no Oklahoma law. The immediacy of the frustration is shown by the fact that a law violation directly preceded and directly followed the expenditure claimed to be deductible." 261 F.2d at 679. To this statutory hodgepodge the dissent added one poignant detail: in more than fifty years of prohibition in Oklahoma, no criminal charges for serving liquor to business guests in private homes had ever been reported. The dissent also pointed out that it is difficult to see how severely and immediately a violation of a law which has never been enforced can frustrate public policy.

The taxpayer in *Al J. Smith*, 33 T.C. 861 (1960) also attempted to deduct the cost of liquor served to his business guests. One Mississippi state law prohibited the sale, possession, and giving away of any intoxicating liquors; another levied a tax on the sale of all illegal commodities, providing an important source of Mississippi revenue from taxes on liquor sales. The Tax Court found that these apparently conflicting statutes established a sharply defined state policy which the taxpayer's purchases had frustrated and violated, and denied the deduction.

³⁰ 315 F.2d 439 (5th Cir. 1963), *aff'g* 207 F. Supp. 84 (E. D. La. 1962).

and consent of the payees' employers. Affidavits from seventeen foreign shipowners stated that the owners either did not know of the practice of paying kickbacks, or knew of the practice but vigorously objected to it. The kickbacks were held illegal under the Louisiana statute, and the Fifth Circuit denied deductions of \$41,940.01 for 1951 and of \$79,311.43 for 1952.

In *Coed Records, Inc.*³¹ the record manufacturer-taxpayer claimed that its payola payments to disc jockeys did not violate the New York commercial bribery statute which forbade making such payments without knowledge and consent of the payees' employers. It said that the making of payola payments was so widespread that the station owners' consent could be inferred. The Tax Court held that not even the showing of a widespread payola practice could establish owners' knowledge and consent, and that, even if it could, such a showing had not been made by the taxpayer. The record company's payments were held illegal under the New York commercial bribery statute and their deduction was denied.

The taxpayer in *In re Michaud*,³² a meat purveyor, had paid kickbacks of three percent of his gross sales to managers, chefs, and other purchasing agents of clubs, hospitals, hotels, and similar institutional customers. The Internal Revenue Service contended that the payments constituted an unfair or deceptive commercial practice within the meaning of the Packers and Stockyards Act of 1921 and that they violated commercial bribery statutes of the states in which the taxpayer conducted his business. The taxpayer presented no direct testimony about the extent or the legality of the custom, but cited the Internal Revenue Service practice of routinely auditing the tax returns of all taxpayers in the wholesale food industry in the Philadelphia area on the grounds that the custom of paying kickbacks was widespread and that a formula for disallowing the deduction of twenty-five to fifty percent of all claimed promotion expenses had been adopted. The district court found this evidence of Internal Revenue Service policy inconclusive on the question of the extent of the practice of paying kickbacks. In addition, the taxpayer had submitted no testimony to show that the payments had been made with the payees' employers' consent, a necessary element in showing the payments to be legal under the bribery statutes and therefore deductible. The court concluded that the taxpayer "failed to carry his burden of proof as

³¹ 47 T.C. 422 (1967).

³² 317 F. Supp. 1002 (W.D. Pa. 1970), *rev'd on other grounds*, 458 F.2d 953 (3d Cir. 1972).

to the knowledge of the employers of the recipients, or custom of the industry."³³ The deductions were denied.

3. Shifting the Burden of Proof in Determining the Taxpayer's Guilt

The courts that assumed the task of construing state criminal law in federal income tax litigation have encountered problems unforeseen in *Boyle, Flagg & Seaman, Inc.* and *Tank Truck Rentals, Inc.* The first difficulty is that while taxpayers bear the burden of proof in demonstrating that they are entitled to deductions, the prosecution bears the burden of proving the defendant guilty of commercial bribery at a state criminal trial. In the hybrid process of guilt determination and tax litigation undertaken in the cases discussed above, the prosecutor's burden of proving guilt under the criminal charge diminishes and even disappears. In *Coed Records* and *Michaud* the burden of proof was effectively shifted: the Internal Revenue Service presented no evidence of the taxpayers' guilt except for the invocation of the commercial bribery statutes that might have been violated. The taxpayers were left to prove their innocence as an element of their proof that they were entitled to a deduction. This change apparently took the taxpayers in *Coed Records* and *Michaud* by surprise; according to this more stringent standard their evidence was ill-prepared indeed. But the shift of burden has unfortunate consequences: many taxpayers who could not be convicted in a state criminal proceeding could nevertheless be held to have violated a commercial bribery statute for federal income tax purposes only. This tax practice contravenes state policy by distorting the process through which state law, and hence public policy, are determined to have been violated. How this contravention constitutes enforcement of state policy under the public policy doctrine is difficult to see.

One court has addressed this problem indirectly. In *Conway Import Co. v. United States*,³⁴ the taxpayer, a wholesale purveyor of condiments to institutional food customers, paid kickbacks to chefs and stewards in circumstances identical to those in *Michaud*. The district court, finding that the kickbacks had been paid in a secretive manner to ensure continuing purchases, nevertheless held that

It does not follow that the payments were necessarily violations of the statutes against commercial bribery. . . . [The statutes in question] extend their prohibitions only to payments made without the knowledge of the employers. There is some indication that gratuities such as here

³³ 317 F. Supp. at 1009.

³⁴ 311 F. Supp. 5 (E.D.N.Y. 1969).

involved were a matter of common knowledge in the industry. The court in a tax case should not pass on matters which would be defenses in a criminal prosecution.³⁵

The court also concluded that the evidence presented by the taxpayer, including a citation of Internal Revenue practices (similar to those referred to in *Michaud*) and testimony by Conway's president that the payment of kickbacks was customary in the trade (similar to the evidence rejected in *Frederick Steel Co.*), satisfied even the "unnecessarily hostile" standard of *Michaud* and proved the payments were ordinary and necessary. The deductions were allowed because of this proof and because the applicable state statutes were "in a state of innocuous desuetude" or had been "strictly construed."

The public policy doctrine, expressed in *Tank Truck* and *Sullivan*, and under which the opposite results in *Michaud* and *Conway* were reached, does not mention the burden of proving criminal guilt in tax litigation; *Tank Truck's* reliance on *Boyle, Flagg & Seaman, Inc.* limits its direct applicability to cases in which a determination of guilt has been made prior to litigation of the tax issues. *Tank Truck* can be read as implying that such cases are the only ones involving kickbacks to which the public policy doctrine should be applied and in which deductions of kickbacks should therefore be disallowed. However, no such explicit limitation was made. As a result the incorporation of aspects of a state criminal trial into federal income tax litigation, with all its attendant difficulties of construing state statutes and of determining guilt under an ill-defined burden of proof, has been continued since *Tank Truck* through the series of cases discussed above.

4. Examination of the States' Enforcement Policies As an Element of Public Policy

Some courts have been unwilling to find a frustration of public policy when the taxpayer's expenditures have violated "dead-letter" laws, such as the liquor laws under which the deductions claimed in *Winters* and *Al J. Smith*³⁶ were denied. They became mired in yet another problem concerning state enforcement policy, that of the record of enforcement of the state statutes whose violation was claimed to frustrate public policy. As the dissent in *Winters* pointed out, the zeal with which state enforcement agencies prosecute violations of illegal payment statutes is itself an expression of those states' public policy. In *Stacy v. United States*³⁷ a

³⁵ *Id.* at 16.

³⁶ See note 29 *supra*.

³⁷ 231 F. Supp. 304 (S.D. Miss. 1963).

contractor claimed deductions of \$1,038.92 for purchases of whiskey used in business entertainment. In construing the conflicting Mississippi statutes under which the possession and sale of liquor are illegal and the purchase of liquor is taxed, the district court concluded that the prohibition law was directed at persons engaged in the whiskey business rather than private purchasers. It then construed state policy as evidenced by the levying of a tax on all whiskey purchases to approve the purchase of liquor so long as all state revenue requirements were fulfilled and held that "[t]he State has the undoubted power to collect a tax on a business which it condemns and makes illegal but in so doing it just as surely blurs its focus upon any declaration of public policy contained in such a mixed-up scheme."³⁸ Since the taxpayer's purchases complied with all state revenue policies, no public policy had been violated. The public policy evidenced in the prohibition statute, under which the taxpayer in *Al J. Smith* had been denied a deduction three years before, was undercut by the enforcement of a conflicting statute as well as by a newly offered construction of the prohibitory statute itself. The public policy doctrine required federal revenue policy to conform to state policy, if it required anything at all, and the deduction was allowed.

In *Matt R. Kane*,³⁹ a companion case to *Conway*, the Tax Court allowed the deduction of a condiment purveyor's kickbacks to chefs and stewards. An Illinois commercial bribery statute prohibited such payments, but the court held that the payments had not violated public policy for federal income tax purposes because the state had neither taken any action against the taxpayer nor prosecuted anyone else, despite the widespread nature of the illegal practice. In this case the narrow reading of *Tank Truck*, as construed in *Kirtz*, required the same result as did the complicated process of determining public policy as outlined in the cases discussed above. The Tax Court relied heavily upon *Kirtz*' authority to find, without approaching the question of the taxpayer's guilt, that since no prior determination of guilt had been made no public policy issue arose. The court's mention of lack of general state enforcement also linked the case with the cumbersome process that had evolved since the incorporation of guilt determination into tax litigation: the interpretation of a state policy that may never have been declared (through construction of a statute under which few cases may have been brought), the determination of taxpayer's guilt under standards of proof which may not have been articulated, and the sporadic examination of a state's enforcement policies in accordance with public policy theories of a federal

³⁸ *Id.* at 306.

³⁹ 1971 P-H Tax Ct. Mem. 987.

court. The respective results of adopting the narrow and the complex constructions of the public policy doctrine would not be the same for every taxpayer, but enforcement of both federal⁴⁰ and state⁴¹ bribery laws has been so lax that a court which did choose to examine enforcement

⁴⁰ The Federal Trade Commission Act, 15 U.S.C. § 45(a)(6) (1971) provides in pertinent part:

The Commission is empowered and directed to prevent persons, partnerships, or corporations . . . from using unfair methods of competition in commerce and unfair or deceptive acts or practices in commerce.

Bribery is held to constitute an unfair means of competition because of the unfair advantage the bribing seller secures over his nonbribing competitor in the agent's decisions to buy.

From its inception in 1914 until the early 1920's the Commission issued about a hundred cease and desist orders against payors of commercial bribes. Three court decisions narrowed the scope of its activity. *New Jersey Asbestos Co. v. Federal Trade Commission*, 264 F. 509 (2d Cir. 1920) held that gratuities of gifts and entertainment paid to customers were "an incident of business from time immemorial" which did not affect the public interest, and thus were not an unfair means of competition. *Kinney-Rome Co. v. Federal Trade Commission*, 275 F. 665 (7th Cir. 1921) held that giving small presents to department store salesmen, with their employers' consent, for every sale of the donor's product did not injure competitors whose products were sold in the same stores, and thus was not a means of unfair competition. *Winslow v. Federal Trade Commission*, 277 F. 206 (4th Cir. 1921) held that a Norfolk ship chandler's sales to English ships docked in Norfolk did not constitute interstate commerce, even though the chandler had bought many of his supplies outside Virginia. Thus the appellant was not engaged in interstate commerce and was not subject to control by the Federal Trade Commission. This decision virtually exempted the ship chandlery industry from control by the Commission.

After 1923 the issuance of cease and desist orders declined sharply, not to be revived until the disc jockey payola scandals broke in 1959 and the Commission issued about sixty cease and desist orders against record manufacturer-payors of payola. The complaints were later dismissed when it was established that recent amendments to the Communications Act of 1934, 47 U.S.C. § 317 (1971) fully protected the public interest.

Regrettably, Federal Trade Commission activity in the area of commercial bribery has once again ceased. The Federal Trade Commission Act would seem to be a better vehicle than the state criminal laws for controlling commercial bribery. Since the Commission has broad investigative powers, it could find out what practices exist on an industry-wide basis. Since its strongest sanction is the cease and desist order which can be appealed to a federal court of appeals, investigations might meet with less resistance than a criminal procedure would, and the Commission could even engage in cooperative efforts with industries to stop the flow of kick-backs their members often unwillingly pay. See G. HENDERSON, *THE FEDERAL TRADE COMMISSION* (1924); Note, *Commercial Bribery*, 28 COLUM. L. REV. 799 (1928); Note, *Bribery in Commercial Relationships*, 45 HARV. L. REV. 1248 (1932).

Other federal statutes forbid commercial bribery; See Annot., 1 A.L.R.3d 1350 (1965). Emphasis is given to the Federal Trade Commission Act here because it is the statute the Internal Revenue Service has most frequently chosen to revive and enforce in the name of public policy.

⁴¹ N.Y. PEN. LAW § 180 (McKinney 1967) provides:

A person is guilty of commercial bribing when he confers, or offers or agrees to confer, any benefit upon any employee, agent or fiduciary without the consent of the latter's employer or principal, with intent to influence his conduct in relation to his employer's or principal's affairs.

This statute and its predecessor are the model state commercial bribery statutes. Note, *Control of Nongovernmental Corruption by Criminal Legislation*, 108 U. PA. L. REV. 848 (1960) tabulates the state commercial bribery statutes then in force (only thirteen states had general statutes similar to New York's) and points out that even under the most actively enforced state law (New York's) only seven criminal charges had appeared in the reported cases as of 1960.

policy would tend to allow the deduction of illegal kickback payments for a large proportion of those taxpayers whose guilt had not been previously determined. If the results are to be the same, the former, simpler process is preferable.

If the public policy doctrine with respect to kickbacks and other illegal payments, as enunciated in *Tank Truck* and *Sullivan*, forbade the denial of deductions only where a prior determination of guilt had been made, it was so poorly articulated that the litigation of all subsequent kickback cases except *Kirtz* occurred pursuant to a mistaken reading. If the public policy doctrine required complicated statutory construction and a determination of guilt within the federal income tax system, it was at best careless and mistaken in its invocation of these requirements in contrast to the doctrine that applied to all other expenditures against public policy. In either case, judicial or statutory clarification was needed.

III. PUBLIC POLICY AND ILLEGAL PAYMENTS UNDER § 162(c)(2)

The narrow reading of the *Tank Truck* and *Sullivan* dicta on illegal payments can be viewed as the source of the 1969 version of § 162(c)(2).⁴² That provision required the payer's conviction or plea of guilty or of *nolo contendere* in a criminal proceeding before the payment would be deemed illegal and its deduction disallowed. Section 162(c)(2) was the most narrow reading of the public policy doctrine yet to appear, since under its standards even the payments in *Boyle*, found illegal in a state administrative proceeding, would not violate public policy. Like the narrow reading of the *Tank Truck* dictum it would have kept federal income tax litigation free from the determination of a taxpayer's guilt under laws outside the Internal Revenue Code. The provision was also desirable in that it aligned the treatment of kickbacks with that of all other expenditures against public policy (except bribes paid to government officials) by keeping the scope of the disallowance of deductions confined to those instances in which an individual taxpayer had been found to have violated policy by an enforcement agency of the government which had expressed the policy in the first place.

The statute also dried up the flow of revenue from the disallowance of deductions for kickbacks by allowing their deduction by most, if not all, taxpayers: in all the kickback cases reported before its enactment no taxpayer had been indicted in a state criminal proceeding.

The Senate Finance Committee said it had become

concerned that these provisions . . . unduly restrict the denial of deductions. . . . The committee continues to believe that the determination

⁴² See note 15 *supra*.

of when a deduction should be denied should remain under the control of Congress. However, the committee concluded that the area in which deductions are denied should be expanded somewhat beyond the limits set in 1969.⁴³

The resultant 1971 revision of § 162(c)(2)⁴⁴ is the provision in force today. For the deduction to be denied, the taxpayer need only be subject to, not convicted of or even indicted under, a statute that provides for criminal penalty or loss of license or privilege to engage in a trade or business. This abandonment of the 1969 statute's requirement of conviction or a plea of guilty or nolo contendere permits the reintroduction of the hybrid process of guilt determination in tax litigation as developed in the cases decided before its passage.

To prevent denial of deductions to those taxpayers whose payments violated "dead-letter" statutes, such as those in *Al J. Smith* and *United States v. Winters*, the state law (because of whose violation the deduction is denied) must also be "generally enforced." To prevent the effective shift of the burden of proof of innocence to the taxpayer, the existing provision puts the burden of proof of state statutory violation upon the Secretary of the Treasury or his delegate. These two protective measures are intended to curb the abuses previously present in those cases in which courts declined to examine the enforcement record of a statute, or in which the taxpayer was required to prove his innocence to secure a deduction for a questionable payment. But the protection they offer operates in an uncertain and cumbersome fashion that makes the 1971 provision unsatisfactory in principle as well as in practice.

A. *The Requirement That State Statutes Be "Generally Enforced."*

The requirement of a conviction or of a plea of guilty or nolo contendere in the 1969 law meant that the state's policy under its illegal payment statutes would (or should) already have been ascertained for the taxpayer whose deductions were in question. The present law's requirement of general enforcement of a state statute does not speak to the status of the taxpayer at all, but only to the general status of the law under which the payments are questioned. The requirement of general enforcement as it evolved in cases like *Stacy v. United States* and *Matt R. Kane* served the purpose of broadening the factors to be considered in construing a state statute beyond the language of the statute itself. Although this additional inquiry improved and refined the construction process, its inclusion in the 1971 Revenue Act has an undesirable side effect:

⁴³ S. REP. NO. 437, 92d Cong., 1st Sess. 72-73 (1971).

⁴⁴ See note 16 *supra*.

allows the Internal Revenue Service to exercise discretion in defining the scope of its enforcement of state statutes in a manner which may violate, rather than serve, a state's policy with respect to that law.

No matter how generally enforced a state statute is, some taxpayers who violate the statute will not be convicted under it. Their escape from the legal consequences of their violations may be due to various factors: inadequate state enforcement, insufficient evidence against taxpayers, or exercise of the state's discretion not to prosecute. Under the present version of § 162(c)(2) the Internal Revenue Service may nevertheless prove such a taxpayer's guilt under the statute and deny the deduction of payment only if it has determined illegal.

A state's practical inability to enforce its own statute has regrettably been seen as all the more reason for the Internal Revenue Service to help with the punishment of offenders. In *G. E. Fuller*, where the cost of illegally purchased liquor subsequently seized by state police was held nondeductible, the Tax Court said, "only lack of complete administration of the existing statutes prevented petitioner from losing the whiskey the moment he was found with it in Oklahoma."⁴⁵ But is not the weakness of a state's enforcement efforts itself an expression of public policy? The finding of guilt in a federal income tax proceeding and the denial of deduction within the federal income tax system does not reflect a permissible form of federal aid to inadequately financed and staffed police departments, but rather preemption and distortion of a state's enforcement policies.

If a state cannot gather sufficient evidence to convict a taxpayer who has made illegal payments, the Internal Revenue Service's access to that person's tax returns and the confidential information they contain may result in a determination of guilt which could not have been independently made by a state agency. Whether the use of such information, whose introduction into a state proceeding might not be allowed, enforces state policies regarding a defendant's procedural protections is questionable. And if a state in the exercise of its discretionary powers chooses not to prosecute a taxpayer for the making of even clearly illegal payments, the determination of guilt and the denial of deduction within the federal income tax system can only contravene or frustrate the state's public policy.

The general enforcement requirement could also act to allow deductions for payments which are abhorrent to state policy. If a notorious taxpayer has been convicted of commercial bribery in an isolated state

⁴⁵ 20 T.C. at 318.

trial, his payments might be deductible because the law under which he was convicted was not generally enforced.

This replacement of the requirement of state action against an offender before a deduction can be denied with the requirement that the statute be "generally enforced" not only frees the Internal Revenue Service to disallow deductions to taxpayers not previously found guilty, but also absolves the Service from the requirement that it show any relation between the class of taxpayers convicted or reprimanded under state law and the class of taxpayers to whom it denies deductions for illegal payments. In other words, the Internal Revenue Service may evolve a discretionary enforcement policy that not only fails to coincide with, but may even contradict, the discretionary policy of the state. The equivalent of this power in the area of fines and penalties is officious intermeddling at best. If a state could not or would not enforce its motor vehicle maximum weight statutes, and from information given on a taxpayer's return the Internal Revenue Service was able to calculate that the taxpayer had violated those statutes, the public policy doctrine as regards fines and penalties would not permit the Service to disallow deductions of the fines which would have been exacted had the state held the taxpayer in violation of the law. Such an excursion into hypothetical state law enforcement is hardly demanded in the name of comity, yet its counterpart is allowed for the denial of deductions of commercial bribes and kickbacks because of the words "generally enforced." This unique jurisdiction to preempt, distort, and even contradict state enforcement policy on illegal payments seems an inappropriate means for implementing a tax doctrine whose justification lies in the necessity to conform to public policy as expressed by a state.

Although the words "generally enforced" do not provide protection from the denial of a deduction for any taxpayer or class of taxpayers, they may be seen as an effective general limitation of the denial of deductions. Since the lack of general enforcement of a state statute precludes the disallowance of the deduction of a payment forbidden by that statute, and since enforcement of state commercial bribery statutes is so sporadic as not to constitute "general enforcement" in the usual sense of those words, a blanket allowance of deductions under § 162(c)(2) seems appropriate.

The words "generally enforced" have not yet been judicially construed so that the frequency with which state statutes will be found to have been generally enforced, and hence to be appropriate bars to deductions claimed under § 162(c)(2), is as yet unknown. "Generally enforced" could reasonably be construed to mean any degree of law en-

forcement between (but not including) the extremes of "dead-letter" status and that of the specific state action taken against the taxpayer in *Boyle, Flagg & Seaman, Inc.* or required by the 1969 version of the § 162(c)(2). Since this range of permissible interpretations remains great, it is difficult to predict which statutes will be found not "generally enforced," and hence it is difficult to predict which classes of taxpayers will be provided with a blanket exemption from the public policy doctrine through the subsequent allowance of deduction of their illegal payments.

Proposed Treasury Regulation § 1.162-18(b)(3) provides that a state law

shall be considered to be generally enforced unless it is *never enforced* or the only persons normally charged with violations thereof in the State (or the District of Columbia) enacting the law are infamous or those whose violations are extraordinarily flagrant. For example, a criminal statute of a State shall be considered to be generally enforced unless violations of the statute which are brought to the attention of appropriate enforcement authorities do not result in any enforcement action in the absence of unusual circumstances.⁴⁶

The regulation provides for so broad a reading of "general enforcement" that almost any activity would constitute general enforcement.

The exclusion of laws never enforced from the definition of general enforcement does prevent the denial of deductions for payments prohibited by "dead-letter" statutes. The exclusion from that definition of laws invoked only against infamous offenders or those whose violations are flagrant may raise more problems than it solves, since enforcement of state commercial bribery statutes, at least, is so infrequent that any person brought to trial for their violation becomes notorious. Further, this part of the definition seems to allow the deduction of illegal payments by some infamous and notorious offenders, since the laws under which only they have been charged are those which by definition are not generally enforced. At the same time, such deductions would be denied to the most retiring and discreet offenders—those against whom no state action had been taken—if the laws in whose violation their payments have been made have been generally enforced.

The exclusion from the definition of "generally enforced" of statutes whose reported violations result in no enforcement action by appropriate authorities appear to be a codification of the facts and holding of *Kirtz v. United States*. There the Ohio Superintendent of Insurance took no action against or even notice of the taxpayer's illegal rebates

⁴⁶ Proposed Treas. Reg. § 1.162-18(b)(3), 37 Fed. Reg. 25937 (1972) (emphasis added).

even after he had been informed of their payment. In support of its allowance of the deduction of these payments, the Court of Claims said that the allowance for deductions of illegal payments extends to *all* cases in which no state action, such as the administrative reprimand referred to in *Boyle, Flagg & Seaman*, has previously been taken against the taxpayer. The *Kirtz* pattern is used in the proposed regulation to promulgate a policy under which *no* deduction of illegal payments is allowed unless a state enforcement agency, notified of statutory violations, nevertheless fails to take any action against the offenders. This example describes a "dead-letter" statute which, in addition to being defunct, has received official burial.

If the Proposed Treasury Regulation § 1.162-18(b)(3) is meant to illustrate the term "never enforced," the example goes beyond any common understanding of that term's meaning of a "dead-letter" statute which enforcement authorities have allowed to lapse or failed to enforce in the normal course of their duties, toward the meaning of a law which enforcement agencies have positively refused to enforce at all. If all laws except those which are "never enforced" under this extremely narrow standard are "generally enforced," then taxpayers may be denied deductions for payments illegal under statutes which are "dead-letter" laws in the ordinary sense, such as liquor laws under which the deductions in *United States v. Winters* and *Al J. Smith* were denied. Thus the apparent protection which § 162(c)(2) offers by the words "generally enforced"—that of forcing a court to examine the enforcement record of an illegal payment statute before denying a deduction for a payment made in its violation—may be no protection at all. If "not generally enforced" means something so narrow as "not enforced against the taxpayer in question when his violations were brought to the attention of enforcement authorities," then the taxpayer's payments in *Kirtz* are the only ones in the illegal payment cases decided until now whose deductions would be allowed under the present statute.

The definition of "generally enforced" in Proposed Treasury Regulation § 1.162-18(b)(3) may not operate so broadly as to deny almost all deductions; but the manner in which the regulation interprets the statute and in which the example illustrates the regulation make it difficult to predict the status of any taxpayer under § 162(c)(2). That section defines the taxpayer's status in terms of enforcement of the state statute alleged to have been violated. Proposed Treasury Regulation § 1.162-18(b)(3) in turn defines and illustrates the enforcement status of the state statute in terms of its past application, without specifying how a state's failure or refusal to take action against an individual taxpayer

whose deductions are questioned will affect him for federal tax purposes. Hence, it is at present virtually impossible for a taxpayer to determine whether his illegal payments are deductible. This lack of any predictable relation between the enforcement of a state statute and the denial of deductions for illegal payments as they affect individual taxpayers is in sharp contrast to the manner in which the denial of deductions for fines and penalties operates under the public policy doctrine. It also casts doubts upon the degree to which state policy is actually intended to be enforced under § 162(c)(2) and the proposed regulation; the criteria of § 162(c)(2) as defined by the proposed regulation may allow federal income tax policy not only to exceed the requirements of the public policy doctrine but to act completely independently of them. This disjunction is indefensible in terms of the public policy doctrine requirement that the net income basis for taxation be distorted only for pressing reasons of intergovernmental comity.

Even if Proposed Treasury Regulation § 1.162-18(b)(3) articulates a definition of "generally enforced" that conforms to requirements of the public policy doctrine, it does so in terms capable of differing interpretation and hence leaves unresolved the scope of § 162(c)(2)'s application. For how long must a statute, once actively enforced, be allowed to sink into disuse before it can be considered "never enforced"? What sort of offender will be treated an "infamous" person or one "whose violations are extraordinarily flagrant"? What constitutes a violation of the statute brought to the attention of appropriate enforcement authorities? If the Internal Revenue Service reports what it believes to be a violation of a state illegal payment statute and no enforcement action follows, the state enforcement agency may have determined that no violation has occurred under its interpretation of the statute, or it may have believed that a violation took place, but declined to enforce the statute. Only in the latter case would state law be held not generally enforced for purposes of § 162(c)(2), but silence and inaction by the state enforcement agency would leave undetermined which conclusion had been reached.

What constitutes an enforcement action which would show the law to be generally enforced? The issuing of a reprimand without fine or loss of license which preceded *Boyle*, the seizure of goods illegally purchased as in *G. E. Fuller*, the bringing of a case later dismissed for lack of evidence as in *Hiram E. Bowles*, or the indictment of the taxpayer's payee as was done in connection with *Coed Records, Inc.*, might or might not constitute enforcement action whose occurrence renders a state statute "generally enforced" and thus a source for disallowance of illegal

payment deductions claimed by other taxpayers against whom no enforcement action had been taken, pursuant to the definitions in Proposed Treasury Regulation § 1.162-18(b)(3).

One writer has said that the proposed regulation's definition of "generally enforced" as meaning anything beyond no enforcement at all shifts the burden of proof to the taxpayer.⁴⁷ Section 162(c)(2) puts upon the Secretary of the Treasury or his delegate the burden of proof of guilt under the state statute which the taxpayer's payments are alleged to have violated. The burden of proving the allowability of a deduction claimed under § 162(c)(2) remains, however, on the taxpayer. If the words "generally enforced" add an element to the steps necessary in the construction of state law, as did the examination of enforcement policies in the cases decided before the enactment of § 162(c)(2), the Government's burden of proving guilt means that the very looseness of the terms used by the proposed regulation in its definition of "generally enforced" offers defenses behind which the taxpayer can entrench himself. The only burden left for the taxpayer to bear would be that of the nuisance of preparing claims that the statute under which his deductions have been disallowed has never been enforced, that other offenders against whom enforcement action has been taken are notorious or their violations flagrant, that "violations" brought to the attention of state enforcement agencies were not violations at all, or that the action taken by the enforcement agencies did not constitute enforcement action.

If, on the other hand, the words "generally enforced" operate only to define the scope of § 162(c)(2) in its disallowance of deductions, then the burden of proving deductibility which remains on the taxpayer requires that he prove those claims which need only be asserted if those words are ones of construction.

Neither § 162(c)(2) nor Proposed Treasury Regulation § 1.162-18(b)(3) assigns the burden of proving that a state statute is "generally enforced." Even if that burden is the taxpayer's, the terms of the definition offered in the proposed regulation provide a framework for proving claims that a state statute is not generally enforced which are more detailed and helpful in the preparation of a taxpayer's claim than the words "generally enforced" alone.

No cases have as yet been reported under § 162(c)(2).⁴⁸ When

⁴⁷ Meltzer, *Are Proposed Kickback Regulations an Unwarranted Extension of the Code?*, 38 J. TAXATION 166, 168 (1973).

⁴⁸ The issue of its scope has arisen, however. In *Raymond Mazzei*, 61 T.C. 497 (1974) the taxpayer was denied a theft loss deduction under § 165(e) for \$20,000 stolen by confidence men after he had contributed it for reproduction in what he believed to be a counterfeiting scheme. The thieves had never intended to reproduce the currency and their sole object was

cases do arise, and especially if Proposed Treasury Regulation § 1.162-18 is adopted, litigants will learn that the words "generally enforced" introduce a jungle of conflicting and vague criteria for determining what state policy is, and how or whether the public policy doctrine should conform to it, far more impenetrable than the standards evolved in case law prior to the passage of § 162(c)(2).

B. *Federal Statutes and Public Policy under § 162(c)(2)*

No requirement of general enforcement, or of any degree of enforcement at all, limits the discretion of the Internal Revenue Service in its denial of deductions for payments forbidden by federal statutes. For federal statutes that have not been enforced by the agencies normally charged with their enforcement, denial of deductions for payments they forbid does not merely preempt, distort, or contravene public policy (as it may with regard to state statutes), but creates public policy and enforces it within the federal income tax system at one stroke.

The systematic creation of public policy by the Internal Revenue Service can be seen by examining the revenue rulings that promulgate standards for tax enforcement of federal statutes. The statute most frequently invoked in these rulings is the Federal Trade Commission Act⁴⁹ forbidding the use of unfair methods of competition, or of unfair or deceptive acts or practices, in commerce. Revenue Ruling 54-27⁵⁰ reports that the Commission had informed the Internal Revenue Service that

under certain conditions the practice by sellers . . . of paying money or making gifts to employees or agents of customers or prospective customers, or to employees or agents of competitors' customers or prospective customers, is an unfair method of competition in violation of Section 5 of the Federal Trade Commission Act, as amended.⁵¹

For a payment to constitute an unfair method of competition, it must

to steal from their victim. The Tax Court denied the loss deduction on public policy grounds because the payment, although not itself illegal, was so closely connected to an illegal activity that the allowance of a deduction would "immediately and severely frustrate the clearly defined policy" against counterfeiting United States currency. A dissenting opinion stated that, since Congress had codified the public policy doctrine in the 1969 and 1971 additions to § 162, the provisions of that section were intended to be all-inclusive. Therefore Congress had "intended to remove public considerations from the Internal Revenue Code where not specifically included" or had at least "called for judicial restraint" in areas where deductions were not specifically limited by public policy statutes.

The majority opinion use of language from the *Tank Truck* test appears to indicate that the public policy doctrine as codified in § 162 supplants the previous standards developed by courts only in the case of expenditures claimed as business expense deductions. The public policy governing losses will still be found in *Tank Truck* and the cases which follow it.

⁴⁹ 15 U.S.C. § 45(a)(6) (1971).

⁵⁰ 1954-1 CUM. BULL. 44.

⁵¹ *Id.* at 45.

have been made for the purpose of influencing the payee, and without the knowledge or consent of the payee's employer. The Ruling provides that payments whose legality was questionable according to the Federal Trade Commission criteria could be deducted if they were normal, usual, and customary in the taxpayer's business and community—that is, *ordinary*; if they were appropriate and helpful in obtaining business—that is, *necessary*; and if they were made with the knowledge and consent of the payee's employer—that is, not illegal under the second criterion of the policy of the Federal Trade Commission.

Cases following this ruling involved taxpayers in the ship chandlery industry, a business whose bribery practices the Federal Trade Commission had sought to control in its first issuance of cease and desist orders forty years earlier. In *Fiambolis v. United States*⁵² a ship chandler's kickback payments to ships' officers were found to conform to the requirements for deductibility promulgated by Revenue Ruling 54-27 and thus not to violate public policy. The kickbacks were also held not to violate the South Carolina commercial bribery statute since criminal intent on the part of the taxpayer, required for conviction under the statute, was not shown.⁵³

Revenue Ruling 58-479⁵⁴ acquiesces in *Valetti* and restates the criteria of Revenue Ruling 54-27 with specific reference to the ship chandlery industry alone. It quotes the *Lilly* pronouncement that ordinary and necessary payments will be deductible unless they "frustrate sharply defined national or state policy." Cases following this ruling include *Dixie Machine Welding & Metal Works, Inc. v. United States*⁵⁵ as well as the leading cases of *Sullivan*⁵⁶ and *Tank Truck*.⁵⁷

Revenue Ruling 62-194⁵⁸ adopts the district court decision in *Dixie Machine* and incorporates it into a general summary of tax policy under federal law. It points out that Dixie Machine's payments were illegal under Louisiana law because they were made without the shipowners'

⁵² 152 F. Supp. 10 (E.D.S.C. 1957).

⁵³ In *Eugene Richardson*, 1957 P-H Tax Ct. Mem. 439, *aff'd* 264 F.2d 400 (4th Cir. 1959), the Tax Court relied on *Fiambolis* to hold that a ship chandler's kickbacks to captains of foreign ships did not violate public policy. The Fourth Circuit affirmed that decision, but specifically cited Revenue Ruling 54-27 and its criteria as the basis for its holding.

In a third ship chandlery case, *Valetti v. Commissioner*, 260 F.2d 185 (3d Cir. 1958), *aff'g on this issue* 28 T.C. 692 (1957), no public policy issue was raised but the taxpayer's deductions were allowed, in part because they were found ordinary and necessary according to tests promulgated in *Lilly*, note 7 *supra*.

⁵⁴ 1958-2 CUM. BULL. 60.

⁵⁵ See note 30 *supra*.

⁵⁶ See note 3 *supra*.

⁵⁷ See note 4 *supra*.

⁵⁸ 1962-2 CUM. BULL. 57.

knowledge or consent, and that shipowners' knowledge and consent constitute one of the conditions under which deductions could be allowed according to Revenue Ruling 58-479⁵⁹ and Revenue Ruling 54-27.⁶⁰ The ruling does not speak of federal statutes except to say that "[m]any Federal laws and regulations make kickbacks illegal under certain circumstances and, therefore, they are not deductible where such statutes or regulations are applicable."⁶¹

The Internal Revenue Service continues to view the ship chandlery industry with concern. Proposed Regulation § 1.162-18(b)(5)⁶² gives as an example of the application of Proposed Regulation § 1.162-18(b) a fact pattern identical to that in *Dixie Machine* except for a changed date and the amount claimed as a deduction.

Another industry against whose members the Federal Trade Commission had formerly issued complaints is the record manufacturing industry. Revenue Ruling 62-133⁶³ recalls that on December 6, 1959, the Commission had issued a news release announcing the filing of numerous complaints against record manufacturers on the grounds that payola payments made to disc jockeys restrained competition and deceived the public thus constituting an unfair business practice under the Federal Trade Commission Act. The complaints were later withdrawn when amendments to the Federal Communications Act⁶⁴ appeared to protect the public interest in radio sponsorship.⁶⁵

Revenue Ruling 62-133 declares that the Federal Trade Commission news release "was an expression of sharply defined Federal policy against 'payola' "⁶⁶ and that payola payments made on or after that date therefore violate public policy and are not deductible. The deductibility of payola payments made on or after that date were to be decided on a case-by-case basis, with deduction denied if the payments were "found to have frustrated a sharply defined public policy proscribing particular types of conduct expressed by a particular state"⁶⁷ before the news release.

The activity of the Federal Trade Commission in relation to the ship chandlery and record manufacturing industries was involuntarily

⁵⁹ See note 54 *supra*.

⁶⁰ See note 49 *supra*.

⁶¹ 1962-2 CUM. BULL. at 58.

⁶² See note 46 *supra*.

⁶³ 1962-2 CUM. BULL. 45.

⁶⁴ 47 U.S.C. § 317 (1971).

⁶⁵ See note 40 *supra*.

⁶⁶ 1962-2 CUM. BULL. at 46.

⁶⁷ *Id.* at 46. In *Coed Records, Inc.*, 47 T.C. 422 (1967), payola payments made in 1958 and 1959 were denied deduction on the latter grounds when they were held to have been made in violation of New York's commercial bribery statute.

curtailed, in the former by a now obsolete court construction of what constitutes interstate commerce,⁶⁸ in the latter by statutory usurpation by the Federal Communications Commission. In both instances the willingness of the Internal Revenue Service to formulate and enforce tax policies which replace Federal Trade Commission activity seems unnecessary and misplaced. The Commission could easily revive its investigation of the ship chandlery industry, and its failure to do so may itself be an expression of a public policy of apathy which Internal Revenue Service denial of deductions for kickback payments distorts. Since the Federal Communications Commission is now charged with the control of payola payments, the Internal Revenue Service policy of denying deductions under now obsolete Federal Trade Commission standards is moreover at least unnecessary duplication, and perhaps even enforcement of a policy which no longer exists. The denial of deductions under § 162(c)(2) for payments which violate federal laws, without even the minimal requirement that those federal laws be "generally enforced," allows the Internal Revenue Service to create and enforce federal nontax policies in what is really a policy vacuum. Section 162(c)(2) allows the Internal Revenue Service to act as a corpse-reviver for federal policies which, however laudable at their inception, may now be obsolete or extinct. Worse, the statute casts the Service as an institutional resurrection man whose source of revenue is the exhumation of federal statutes clearly dead and mercifully buried. The requirements of intragovernmental comity do not call for such a policy and may even reasonably forbid it.

IV. CONCLUSION

Tax policy under § 162(c)(2) appears to have spawned a hydra-headed monster. Good faith enforcement of state and federal policies through the tax system at the pre-enforcement stage demands an effort to duplicate those policies and the procedures under which they would otherwise be enforced. The more care Congress and the Internal Revenue Service exercise to incorporate the protections of a state criminal or federal regulatory enforcement proceeding into federal income tax litigation, the more complexities arise. Some policy or procedural protections cannot be duplicated. Apart from the difficulty of construing state and federal bribery laws and of applying state enforcement policies or of even deciding what they are, there remain those elements of state enforcement policy present in the number of counts of violations with which criminal defendants are charged, the possibly unpredictable conviction patterns of juries, and the discretion judges may exercise in fining or

⁶⁸ See note 40 *supra*.

sentencing offenders, all nuances of policy impossible to duplicate in the simultaneous determination of statutory violation and federal income tax liability.

These difficulties in tax policy formulation all stem from the fact that kickbacks, unlike fines and penalties, are denied deduction at the pre-enforcement stage. To understand and enforce a state or federal policy as it might have applied to an unconvicted taxpayer is much harder than applying it to one who has already been convicted and fined. For this reason alone, a broad reading of *Tank Truck's* statement that "the frustration of state policy is most complete and direct when the expenditure for which deduction is sought is itself prohibited by statute"⁶⁹ seems wrong. The frustration of public policy is most complete and direct when a taxpayer has been held by a state to have frustrated its policy—that is, when he has been convicted in a criminal proceeding or fined pursuant to some other procedure. Even when this most direct frustration of state policy has occurred, comity with states' enforcement policies would seem to demand that only the fine exacted as an expression of the states' displeasure at their policies' frustration, not the payment which occasioned the violation of the law, be denied deduction.

The denial of deduction for fines and penalties is often defended on the grounds that to allow their deduction would lessen the economic "sting" of the penalty the state inflicts. No such arguments are available for the denial of deduction to kickback payments, which are not the economic equivalent of a fine or penalty used to punish an offender, but represent the cost of committing the crime. State commercial bribery laws typically provide for fining offenders. A taxpayer who has been convicted under such a statute will be denied deduction of the fines assessed against him, and the further nondeductibility of the illegal payments themselves adds a second penalty for which state law does not provide. Denial of deductions for illegal payments made by unconvicted payers may be a good-faith effort to inflict in duplicate the financial losses which would have been suffered had the taxpayer been convicted and fined. However, since the amount denied deduction is the cost of committing the crime, not the amount of a hypothetical penalty, the amount of the tax punishment may bear no relation at all to the fine which otherwise might have been exacted.⁷⁰ Denial of deductions for payments which violate federal statutes is even less justifiable for punishment-duplicating

⁶⁹ See note 20 *supra*.

⁷⁰ Comments, *Business Expenses, Disallowance, and Public Policy*, 72 YALE L.J. 108 (1962) gives an excellent description of the disparity between the severity of the punishment provided for by state and federal illegal payment statutes and that inflicted under the tax policies formulated to aid in their enforcement.

reasons, since those statutes often do not provide for the assessment of any fines at all.

The present version of § 162(c)(2) is a mistake. There are good reasons for denying deduction to some illegal (and legal) kickback payments, but the public policy doctrine is not one of them. Kickback payments can be denied deduction if they are not ordinary and necessary business expenses (so long as courts abandon the practice of incorporating public policy criteria into their tests for "ordinary" and "necessary"), if they have not been sufficiently substantiated under the requirements of § 274(d), or if they represent personal rather than business expenses. These reasons for disallowing the deduction of any claimed business expense are satisfactory both as reasonable tests for what all business expenses ought not to be and as a summary of the qualities that are most offensive about kickbacks.

Renewed enforcement of state and federal commercial bribery statutes by the agencies originally charged with their administration is the only appropriate means of punishing the payers of kickbacks. The use of the Internal Revenue Code as an instrument for the enforcement of nontax laws is distasteful in principle and so complicated in practice that its abandonment is dictated.

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